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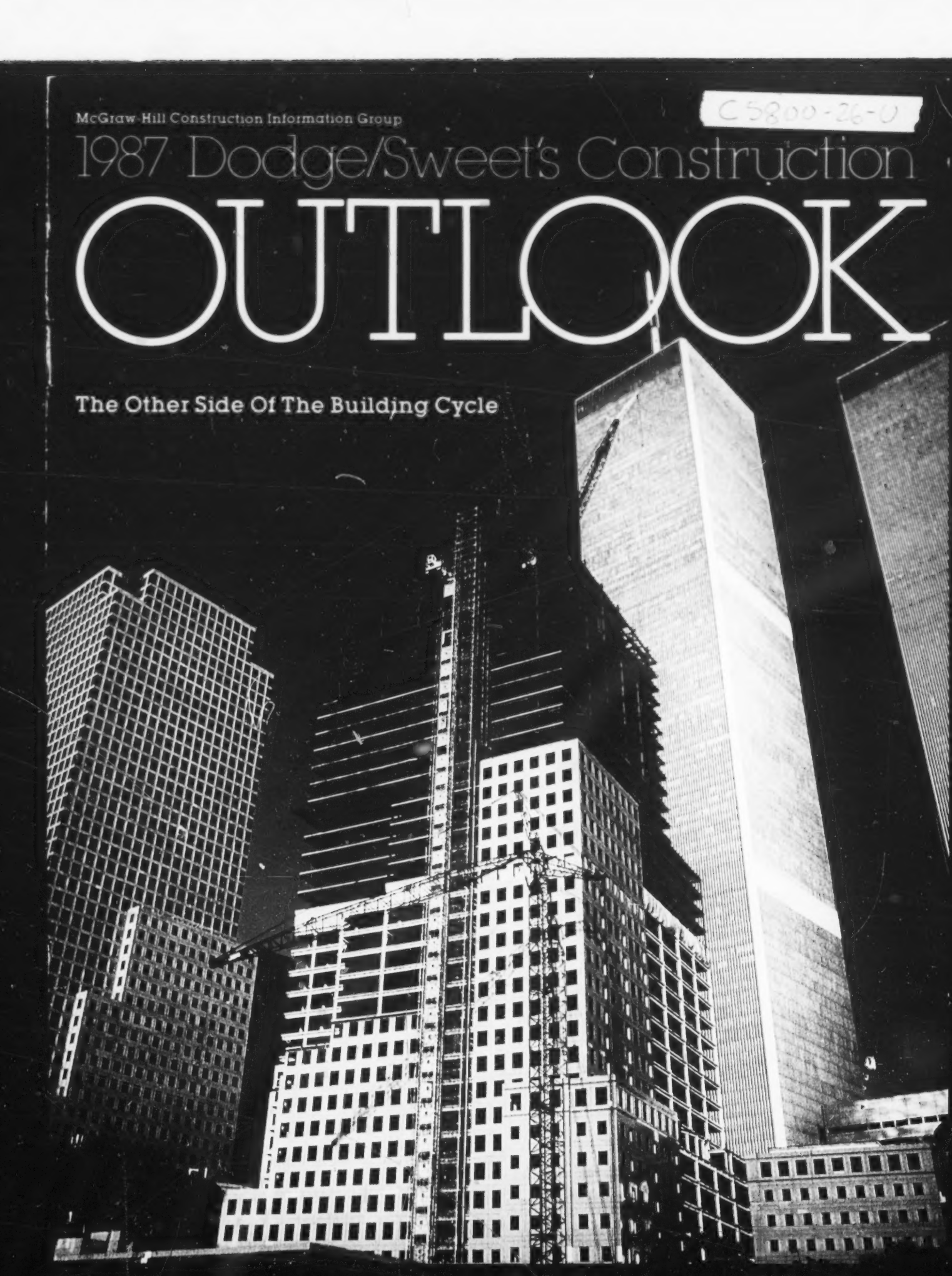
1987 Dodge/Sweet's Construction OUTLOOK

The Other Side Of The Building Cycle



The Other Side Of The Building Cycle

Take It From The Top

There are only two ways to go from the peak of a building cycle: sideways or down. In 1986, the construction market extended the peak of three years of expansion by taking the sideways route. Improved housing activity "covered" the recent slippage of commercial and industrial building, and total construction contracting–the sum of all newly started projects–added a fourth good year to the string that began in 1983.

The trade-off between residential and nonresidential construction that stretched the peak of total contracting through 1986 can't work much longer. Nonresidential building has been declining since late in 1985, and will slip more in the year ahead. Housing will remain the strongest part of the construction market in 1987, but not strong enough to continue offsetting the weakness in the nonresidential sector. Instead of another gain in housing next year, a modest decline is more likely as multifamily demand softens. When that happens, the momentum will be lost.

After a longer than average period of expansion, it is time for a look at the other side of the building cycle. There's nothing new about the recurrence of a cyclical decline of construction activity. It happens about every six years, give or take a year. (The last two general downturns of the building market happened in 1980 and in 1974.) What makes the difference between one cyclical decline and another is the political and economic environment in which they happen. The downturn that is now beginning promises to be quite different from the previous one (1980-1982), principally because circumstances are anything but the same.

The last time the building market came off a peak, its downfall was triggered by extraordinary credit conditions. When the Federal Reserve declared all-out war on inflation early in the 1980's, severe monetary restraint sent interest rates soaring. Not surprisingly, housing led the construction market into decline. Retail building soon followed. And as the monetary crunch ultimately threw the economy into general recession, industrial construction plummeted to its lowest volume in decades.

Curiously enough, some parts of the construction market were not only unaffected by the early 1980's recession, but actually prospered during it. Two legislative events made all the difference. One, the Economic Recovery Tax Act, became the basis for a boom in office building in the midst of economic adversity by providing the powerful incentive of accelerated depreciation. The other, the Surface Transportation Assistance Act, set up a comparable boom in highway and bridge construction with its 5¢-per-gallon fuel tax. As a result, the major impact of the last cyclical decline of the construction industry was borne by the housing sector, which shriveled under the heat of extreme monetary restraint.

And Now, Something Different

One feature of the coming cyclical decline of construction activity that makes it different from the last one (and most others, for that matter) is already apparent. This one is developing within the *non*residential sector by a weakening of commercial and industrial construction, while homebuilding–usually the first to weaken–continues to flourish.

This unfamiliar experience of backing into decline through the nonresidential side of the construction market is symptomatic of the redirection of national economic policy over the past half-dozen years. As fiscal policy has become increasingly restrictive, monetary policy has become more accommodating. ERTA's supplyside investment incentives have yielded to tax reform and the elimination of real estate tax shelters–not good for offices or apartments. The ballooning Federal deficit has triggered a mandate for systematic deficit reduction–not good for public works. Reduced inflation has led to monetary relaxation and the lowest interest rates so far in the 1980's–good for one family housing and other credit-sensitive building types.

These issues–tax reform, deficit reduction, interest rates, and one other, the trade gap –are the ones that will shape the outcome of the building cycle that is now rounding its peak. This different environment for construction is bound to produce some unusual reactions. What happens in 1987 could set a pattern for the next several years.

Nonresidential Building...and tax reform

Nonresidential building turned the corner a year ago. It was in 1985's third quarter that contracting for new commercial, industrial, and institutional building reached its peak at an annualized rate of 1.45 billion square feet. In the four quarters that followed, nonresidential building slid to its current rate of 1.30 billion square feet. And it all happened in advance of tax reform, an event that will soon add another dimension to this already wobbly construction market.

The decline and fall of nonresidential building was consistent with a sputtering economy weakened by a flood of imports. As industrial output sagged and excess manufacturing capacity piled up, corporate America made the conventional response: a cutback of capital spending. Inevitably, construction of unneeded commercial and industrial facilities was deferred until better times. But that was only part of it. While the industrial crescent was adjusting to fierce competition from the Orient, the oil patch was having a recession of its own. The extraordinary Southwestern building boom of the early 1980's left that region overbuilt and vulnerable. When the shock of collapsing oil prices came, construction went. Contracting for nonresidential construction in the West South Central region (Texas, Oklahoma, Arkansas, and Louisiana) plummeted 26 percent in 1986 while the national total retreated 7 percent.

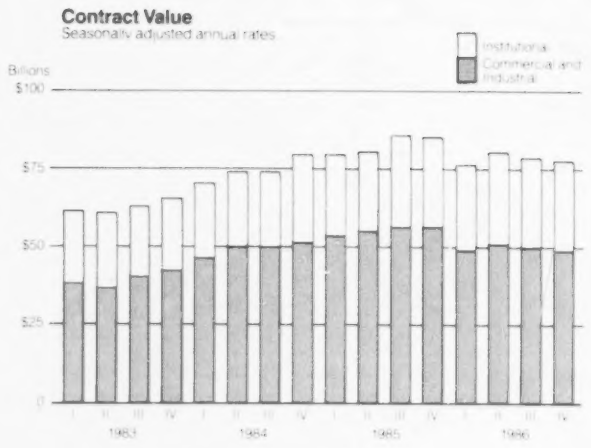
As the nonresidential building market adjusts to its 1986 problems, it must now prepare to cope with an additional handicap in 1987: tax reform. To no one's great surprise, real estate tax shelters headed the list of reforms in the sweeping overhaul of the nation's tax system. The new legislation provides that depreciation on commercial buildings will be extended to 31.5 years from the current 19 years. It further prohibits the use of "passive" investment losses to offset other income. For developers of office buildings (as well as hotels, apartments, and other income-generating properties), the new tax law means that these investments must now exist by rent alone. That is, they must earn a competitive return without the generous subsidy provided since 1981 when the Economic Recovery Tax Act offered the opportunity to create "losses" (by means of accelerated depreciation), which could be used to shelter other income.

In addition, preferential tax treatment currently enjoyed by industrial development bonds, private waste treatment projects, some recreational facilities, convention centers, and even low income housing will be limited (capped) under the revised code. *Public* bond issues for roads, waste water treatment facilities, schools, hospitals, and other local government construction will continue to enjoy tax-free status and the lower cost financing it implies to the borrower, but on terms that are less favorable to institutional investors.

Although there are many other aspects of tax reform that will affect developers, contractors, designers, manufacturers, and investors, none will have the immediate impact that the elimination of real estate tax shelters will. And the main impact will, of course, fall squarely on offices.

Offices Tax reform means getting back to basics–building offices intended to shelter workers instead of income.

To put this issue in perspective, it is well to keep in mind that tax reform will not take away much beyond the powerful but questionable incentive provided in 1981 by ERTA. Since then, the "subsidy" of accelerated depreciation has distorted this market by encouraging the creation of a huge inventory of empty offices. Lengthening depreciation back to 31.5 years will not put the commercial building market at any more of a disadvantage than before ERTA, except for the temporary problem of digesting the glut of vacant offices–the legacy of overstimulation. Beyond this short-term adjustment, which requires a sharp cutback of new construction for a few years, any viable project (i.e., justified on the basis of need) will be just as viable after tax reform as it was before ERTA brought an element of artificiality to this market. Reform will *not* inhibit the



long-term growth of commercial building, which is a matter of demographics and economics, not financial gimmickry.

What will reverting to the "old math" of real estate development (accelerated depreciation being the "new math") mean? To earn a return on investment with 31.5 year depreciation that is comparable to the return provided by ERTA's 19 year write-off will require a higher rent to offset the loss of the tax advantage. But rents will remain depressed until the excess supply of space is taken up. In the meantime, investors will be looking for other opportunities. The need to absorb upwards of 200 million square feet of surplus office space will severely depress new construction for several years.

During this re-entry to reality, a useful benchmark is 250 million square feet–the estimated annual volume of office building that is consistent with the mid-1980's growth of the white collar labor force and other basic elements of the demand for space. After five years of building at a rate well in excess of this sustainable volume (1981-85 averaged 300 million square feet per year), new construction must fall well below the 250 million square foot level until equilibrium is re-established. The adjustment is already in progress, but it still has a long way to go. The decline from last year's 342 million square feet to an estimated 265 million in 1986 barely reaches the benchmark. To achieve a meaningful reduction of the near 20 percent vacancy rate, new construction will fall as low as 150 million square feet. A "second step" in that direction, to 210 million square feet, is anticipated for 1987, with still deeper cuts to follow.

If it were not for the concentration of the office surplus in the Southwest, the decline of contracting for new construction might be steeper and the adjustment process shorter. However, continued construction throughout the less overbuilt Northeast and North Central regions, at a moderately reduced rate over the next few years, will support national volume while the South gradually recovers.

Industrial The long-term decline of the industrial construction market–from an annual volume of more than 300 million square feet in the mid-1960's to just over 200 million square feet by the end of the 1970's–accelerated in the 1980's as the widening trade gap hastened the shrinkage of the nation's manufacturing sector.

After making a good start at recovery from the recession of 1980-82, contracting for industrial construction stalled during the mid-1980's as imports displaced domestic output. In 1986, despite the improvement of the dollar against the yen and mark, the trade balance worsened, industrial production

sagged, capacity utilization declined, and—not surprisingly—industrial construction slipped backwards. Contracting for new manufacturing facilities isn't likely to break out of the 140- to-150-million-square-foot range, (where it has been since 1984), until industrial capacity utilization crosses the 80 percent threshold. And that won't happen until the balance of trade in manufactured goods is reversed.

Some of the conditions needed for an improvement in trade are already in place. With interest rates down and with exchange rates moving in favor of the dollar, the expansion of U.S. exports now depends on strengthening demand in sluggish European and Oriental economies. A gradual narrowing of the trade gap, beginning in 1987, should lead to stability of industrial construction at about 150 million square feet for the next several years. During this period excess capacity will be absorbed and renewed growth will start toward the end of the decade.

Retail Of the three major categories of commercial and industrial construction, retail building offers the best opportunity for short-run support. In response to the current high rate of homebuilding, the derived demand for retail building, with its built-in lag, will remain at near-record levels while industrial and office building are temporarily depressed.

Contracting for retail building (stores/shopping centers, warehouses, garages/service stations, etc.) typically ranges from a low of 300 million square feet per year to a peak of 600 million as it follows the housing cycle. After soaring to 600 million square feet in 1985, retail building settled back to 575 million in 1986. Demand for stores and warehouses will ease further in 1987 to 535 million square feet as multifamily housing adapts to tax reform (see Residential Outlook, p. 7). But anything over 500 million square feet must be considered a good volume for retail building. When it happens three years in a row, it's very good.

Institutional The balance of the nonresidential building sector, which consists of schools, health care facilities, public administration buildings, etc., faces a period of unrealized potential.

Because the underlying need for schools and hospitals is geared to demographics, demand should improve slowly over the balance of the decade when the population "pyramid" will be growing faster at its extremes for a while. Kids and seniors are what institutional building is mostly about.

The gradual turnaround of more than a decade of waning demographic support comes at a time when local governments will be hard-pressed to respond to it. Municipal bonds, the mainstream of funding for schools, hospitals, and other public buildings, have survived the rigors of tax reform with their traditional tax free status largely intact. They remain a dependable financial base for most institutional construction. However, the priority of Federal deficit reduction targets means an ever-tightening squeeze on grants-in-aid to states and local governments at a time when the expiration of Revenue Sharing will be leaving a $4 billion annual gap in their budgets. The upshot: greater demands on limited local funds.

The stand-off of favorable demographics and restrictive economics suggests that the volume of institutional building will not increase much in the near future. Contracting is estimated at 315 million square feet in 1987, a total not far from the 1986 volume.

Total Nonresidential Building Already a year past its peak and facing additional handicaps, total nonresidential building is heading for a 7 percent decline in 1987 to 1.20 billion square feet.

Commercial and industrial building, which slipped 10 percent in 1986 as economic activity lost momentum, now faces an equally large decline in 1987 when tax reform becomes effective. The need to absorb the huge surplus of recently built office space is the single biggest obstacle in the nonresidential building market, but not the only one. The persistence of the trade gap will continue to depress industrial construction for the next two years at least.

Back-up support for the nonresidential building market in 1987 will be available from the types of structures that are associated with homebuilding. The sustained, high level of housing starts through 1986 and into 1987 will continue to create demand for retail facilities and other light commercial buildings as well as for several kinds of institutional construction.

Reaction to the office building boom of the early 1980's will dominate the regional pattern of nonresidential building in 1987. All four major regions will experience a reduced volume of new construction next year, with the largest decline (10 percent) taking place in the overextended South. Nonresidential building in the West is forecast to recede in line with the national average of 7 percent, while the less overbuilt Northeast and North Central regions will show below-average declines of 6 percent and 3 percent in square footage started next year.

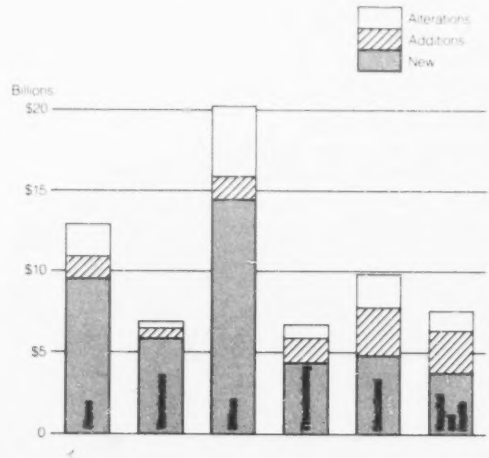
An average inflation rate of 3 percent for nonresidential building in 1987 (reflecting the changing composition of next year's building as well as the cost of materials and labor) will bring 1987 contract value to $74.8 billion, a decline of 4 percent.

Rehab Because the inventory of existing buildings not only grows larger each year but also grows older, there is a built-in element of growth in renovation work that is lacking in new construction.

Major alterations projects currently represent 17 percent of total nonresidential construction contract value, up from 12 percent at the last peak of nonresidential building and 7 percent at the one before that. This steady growth of alterations work offers an alternative market for building products which takes on added interest whenever new construction faces a period of cyclical decline.

The chart below shows the distribution of 1986 nonresidential construction contracting, by selected building type, according to the proportions of new buildings, additions to existing structures, and alterations.

New Construction, Additions, and Alterations
1986 Contract Value in Billions



1987 National Estimates
Dodge Construction Potentials

Nonresidential Buildings	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Floor Area (millions of square feet)			
Office Buildings	265	210	−21
Stores and Other Commercial	575	535	− 7
Manufacturing Buildings	140	145	+ 4
Total Commercial and Mfg.	980	890	− 9
Educational	110	106	− 4
Hospital and Health	72	71	− 1
Other Nonresidential Buildings	138	138	—
Total Institutional and Other	320	315	− 2
Total Nonresidential Buildings	1,300	1,205	− 7
Contract Value (millions of $)			
Office Buildings	$20,200	$16,450	−19
Stores and Other Commercial	22,600	21,750	− 4
Manufacturing Buildings	6,700	7,300	+ 9
Total Commercial and Mfg.	$49,500	$45,500	− 8
Educational	$ 9,775	$ 9,925	+ 2
Hospital and Health	7,525	7,775	+ 3
Other Nonresidential Buildings	11,375	11,650	+ 2
Total Institutional and Other	$28,675	$29,350	+ 2
Total Nonresidential Buildings	$78,175	$74,850	− 4

Residential Buildings	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Dwelling Units (thousands of units*)			
One Family Houses	1,110	1,150	+ 4
Multifamily Housing	740	600	−19
(*F. W. Dodge basis)			
Total Housekeeping Residential	1,850	1,750	− 5
Floor Area (millions of square feet)			
One Family Houses	1,759	1,817	+ 3
Multifamily Housing	707	575	−19
Nonhousekeeping Residential	97	83	−14
Total Residential Buildings	2,563	2,475	− 3
Contract Value (millions of $)			
One Family Houses	$ 83,325	$ 89,075	+ 7
Multifamily Housing	29,625	24,950	−16
Nonhousekeeping Residential	7,000	6,225	−11
Total Residential Buildings	$119,950	$120,250	—

Nonbuilding Construction	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Contract Value (millions of $)			
Transportation Construction	$ 25,825	$ 24,175	− 6
Environmental Construction	13,400	13,850	+ 3
Total Public Works	$ 39,225	$ 38,025	− 3
Utilities	$ 2,000	$ 2,000	—
Total Nonbuilding Construction	$ 41,225	$ 40,025	− 3

All Construction	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Contract Value (millions of $)			
Total Construction	$239,350	$235,125	− 2
Dodge Index (1977 = 100)	170	167	

Total Construction Contract Value
Seasonally adjusted annual rates in billions of dollars

Year	Quarter	Nonresidential Building	Residential Building	Nonbuilding Construction	Total Construction
1986	I	$76.4	$114.0	$39.7	$230.1
	II	80.4	122.7	42.5	245.6
	III	78.4	121.6	41.5	241.5
	IV	77.5	121.5	41.2	240.2
1987	I	$76.5	$120.8	$40.0	$237.3
	II	75.3	120.6	39.7	235.6
	III	74.3	120.4	39.9	234.6
	IV	73.3	119.2	40.5	233.0
1986		$78.2	$120.0	$41.2	$239.4
1987		$74.8	$120.3	$40.0	$235.1
% Change		− 4	—	− 3	− 2

Construction Contract Value in Constant Prices
(Millions of 1982 Dollars)

	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Nonresidential Buildings	$ 72,225	$ 66,800	− 8
Residential Buildings	100,300	96,600	− 4
Nonbuilding Construction	35,650	33,425	− 6
Total Construction	$208,175	$196,825	− 5

1987 Regional Estimates Dodge Construction Potentials

Northeast
CT, ME, MA, NH, NJ, NY, PA, RI, VT

Contract Value (millions of dollars)	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Nonresidential Buildings			
Commercial and Manufacturing	$ 7,875	$ 7,400	– 6
Institutional and Other	4,825	5,100	+ 6
Total	$12,700	$12,500	– 2
Residential Buildings			
One Family Houses	$14,400	$15,675	+ 9
Multifamily Housing	5,500	4,875	–11
Nonhousekeeping Residential	1,050	900	–14
Total	$20,950	$21,450	+ 2
Nonbuilding Construction			
Transportation	$ 5,200	$ 4,950	– 5
Environmental	2,225	2,425	+ 9
Utilities	450	425	– 6
Total	$ 7,875	$ 7,800	– 1
Total Construction	$41,525	$41,750	+ 1

South
AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV

Contract Value (millions of dollars)	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Nonresidential Buildings			
Commercial and Manufacturing	$18,650	$16,275	–13
Institutional and Other	10,750	10,950	+ 2
Total	$29,400	$27,225	– 7
Residential Buildings			
One Family Houses	$32,775	$33,900	+ 3
Multifamily Housing	10,225	8,150	–20
Nonhousekeeping Residential	2,600	2,450	– 6
Total	$45,600	$44,500	– 2
Nonbuilding Construction			
Transportation	$ 9,625	$ 8,900	– 8
Environmental	5,250	5,125	– 2
Utilities	575	625	+ 9
Total	$15,450	$14,650	– 5
Total Construction	$90,450	$86,375	– 5

North Central
IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI

Contract Value (millions of dollars)	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Nonresidential Buildings			
Commercial and Manufacturing	$10,475	$10,125	– 3
Institutional and Other	6,150	6,300	+ 2
Total	$16,625	$16,425	– 1
Residential Buildings			
One Family Houses	$13,900	$15,750	+13
Multifamily Housing	4,775	4,275	–10
Nonhousekeeping Residential	1,175	975	–17
Total	$19,850	$21,000	+ 6
Nonbuilding Construction			
Transportation	$ 5,975	$ 5,625	– 6
Environmental	3,125	3,275	+ 5
Utilities	300	250	–17
Total	$ 9,400	$ 9,150	– 3
Total Construction	$45,875	$46,575	+ 2

West
AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY

Contract Value (millions of dollars)	1986 Preliminary	1987 Forecast	Percent Change 1987/86
Nonresidential Buildings			
Commercial and Manufacturing	$12,500	$11,700	– 6
Institutional and Other	6,950	7,000	+ 1
Total	$19,450	$18,700	– 4
Residential Buildings			
One Family Houses	$22,250	$23,750	+ 7
Multifamily Housing	9,125	7,650	–16
Nonhousekeeping Residential	2,175	1,900	–13
Total	$33,550	$33,300	– 1
Nonbuilding Construction			
Transportation	$ 5,025	$ 4,700	– 6
Environmental	2,800	3,025	+ 8
Utilities	675	700	+ 4
Total	$ 8,500	$ 8,425	– 1
Total Construction	$61,500	$60,425	– 2

Public Works...and deficit reduction

Even if the mandate to reduce the Federal deficit to an "ideal" $144 billion this year misses that target by as much as $20 billion, something important will still have been accomplished. That's the reversal of a trend that has ballooned the annual deficit from $40 billion at the end of the 1970's to more than $200 billion seven years later. Progressive shrinkage of the deficit in the years ahead, even at a rate less than the ambitious Gramm-Rudman targets, will have important consequences for construction—directly by limiting the availability of Federal funds for public works programs, and indirectly by easing pressure on the credit market.

Reducing the deficit from $200 billion to the targeted $144 billion (or even a more realistic $165 billion) in a period of weak economic growth, without raising taxes, requires more than "mirrors and blue smoke." Although the 1987 budget was still not finalized by October 1st, it was reasonably clear that Federal public works programs are slated to be trimmed next year by at least 4 percent on average. This cutback would reduce disbursements for transportation and environmental construction programs *below their 1985 outlays*, with the intent of holding close to that level for several years.

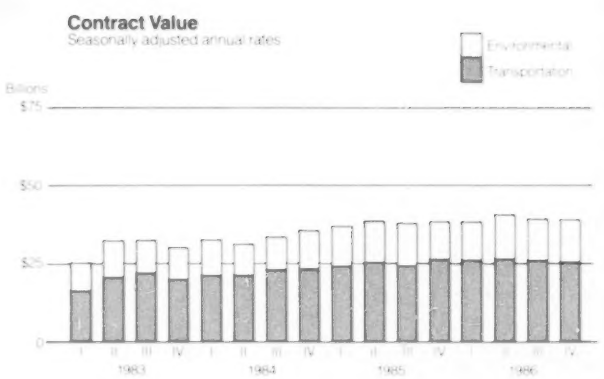
Three major legislative bills currently under consideration by Congress—the Surface Transportation Assistance Act, the Omnibus Water Resources Act, and the Clean Water Act—tell something about the future of public works construction. In the spirit of the "New Federalism," all three provide for the transition from Federal funding to local government financing, or to increased reliance on user taxes, or both.

Although states and localities have already absorbed a larger share of total public works costs over the past several years, they now face new challenges. The elimination of General Revenue Sharing in 1987 will cut $4 billion from local government budgets. Localized recessions in the energy-producing and agricultural regions are temporarily turning state budget surpluses into deficits. Tax exempt municipal bonds for *private* construction will be curtailed by the new reform code. The road to the New Federalism has many potholes.

Transportation Following the 1982 passage of the Surface Transportation Assistance Act with its nickel-a-gallon gasoline tax, highway/bridge construction went on a growth binge. Increases averaged 15 percent annually through 1985—mostly Federally funded. In those three years, the STAA tax escalated the annual total of contracting from $12.3 billion to $19.6 billion, but in 1986 budgetary restraint called a halt to that burst of growth. A modest rise of 6 percent this year, to $20.7 billion, stems entirely from the limited resources of state governments.

Legislation required to extend STAA beyond 1986 and provide future funding for highway, bridge, and mass transit construction still awaits Congressional approval. This forecast assumes passage of the House bill which, though less restrictive than the Senate version, would nevertheless freeze Federal funding of transportation projects for fiscal years 1987 through 1991 at a level *4 percent below 1986 outlays*. The 1987 downward "step" in Federal dollars, along with an expected cutback of state funding (according to a survey of state DOT's), points to an overall decline of 6 percent in current dollar contracting next year (a 10 percent reversal in constant dollar value).

Environmental For the past 15 years, EPA construction *grants* authorized under the Clean Water Act have been the origin of funds for the construction of waste water treatment facilities. It is currently proposed, however, that beginning in 1989, a program of locally administered *loans* be substituted for these Federal grants. For the time being, construction of sewer and waste disposal facilities is dangling between the phase-out of one program and the start-up of the other.



The transition from grants to loans is to be specified in the still unsettled Clean Water Reauthorization Act. For 1987 it must be assumed that either this act or temporary "stop gap" legislation will sustain EPA grant funding at a level close to 1986 disbursements. With the recent, high volume of residential building putting a strain on local waste treatment facilities, higher *local* government outlays—financed mainly by municipal bonds—will boost total contracting for sewer and waste disposal systems by 2 percent to 3 percent in 1987.

Water resources (dams, reservoirs, river and harbor development) are one part of the Federal infrastructure budget capable of sustained expansion over the balance of the decade. Proposed legislation would authorize between 170 and 230 new construction projects (valued at $13 to $20 billion), and the Adminstration is willing to back such water resource development as long as local beneficiaries are willing to share in the cost, as the bill requires.

Total Public Works Construction Without the Surface Transportation Assistance Act, public works construction in the 1980's would have been another story entirely. In its first four years (1982-86), this user fee program has channeled an *extra* $20 billion into the construction of roads, bridges, and mass transit facilities, mainly through its five cent fuel tax. The difference STAA has made amounts to roughly two-thirds of the entire increase in all public works contracting since 1981. Putting a lid on STAA disbursements, as forthcoming legislation proposes, will soon deprive the public works market of its major source of thrust. Nor is there much prospect for growth of environmental construction. The transition from direct Federal funding of waste water treatment facilities to reliance on loans and user fees suggests, in the short run, that less rather than more construction will be taking place.

The five year recovery/expansion of public works construction is now flattening out, but no serious setbacks lie ahead. Following the surge of transportation-related projects, which carried total public works construction from $25 billion in 1981 to almost $40 billion in 1986, contracting is now settling into a $38-to-$40- billion-a-year groove. It will stay there as long as Federal funding is restrained.

One by-product of the Gramm-Rudman deficit reduction targets will be an accelerated implementation of the New Federalism—the transfer of the responsibility for domestic programs from Federal to local government. Public works construction will survive the change—mostly through increased state taxes and a wider application of user fees—but not without an extended period of adjustment when growth will be absent.

The difference between a large and a small decline in total construction contracting next year depends on housing. As long as the residential side of the construction market can retain most of its current vitality, homebuilding will continue to neutralize some of the inherent weakness in nonresidential construction as commercial, industrial, and public works markets ride out their special problems.

The basics–the demographic underpinning of demand for shelter, and the credit that makes demand effective–will remain supportive for a while. But not even the housing market will be completely immune to the issues of 1987. Because *rental* housing has been overdeveloped in recent years by the lure of tax shelters, this part of the market (like offices, but not to the same extent) is due for a correction as tax reform is brought to bear. This puts the burden of sustaining the momentum of the critical residential sector squarely on single family building. The problem: single family building is already so good there's little room for improvement.

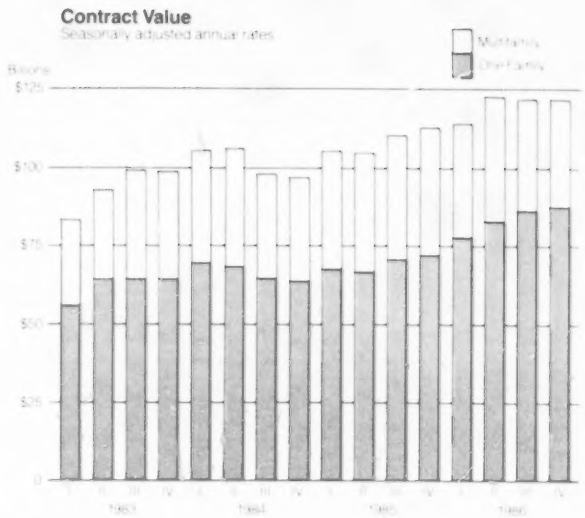
The *demographics* of the housing market change little from one year to the next. Mid-1980's rates of household formation and replacement indicate an *average* annual shelter requirement of close to 2.0 million units. Nontraditional forms of housing (manufactured/mobile homes) supply about 250,000 units of this need, leaving the demand for conventional site-built single and multifamily units between 1.7 and 1.8 million units per year.

For the past several years, housing starts have consistently reached the upper end of this range. Why? Falling mortgage rates offered the opportunity to satisfy an extra layer of *deferred* demand carried over from the depressed early part of the decade. Deferred demand is never a dependable market force, and at prevailing mortgage rates and housing prices it appears to have subsided. In 1986, rising vacancy rates are an indication that for the first time in the 1980's, there is a moderate excess of rental housing. Its existence points up one limitation to sustaining this year's volume of 1.85 million units.

The *interest rate* outlook is more reassuring. There is little justification for a rise in long-term interest rates in the foreseeable future, and more than enough reason why rates should hold (or better, decline a bit more). Inflation is not a serious threat. Stubbornly high real interest rates are an important contributor to the trade imbalance and need to be brought down. But more urgently, the combination of deficit reduction and tax reform in 1987 will bring an unwelcome dose of fiscal drag to an already burdened economy. As Federal revenue outpaces expenditures, and as the business sector is required to bear a larger share of the tax load, the economy will be deprived of whatever stimulus it now draws from these sectors.

Fiscal drag is a handicap to economic growth under any circumstances. It is particularly unwelcome at a time when an adverse trade balance is already depressing the industrial sector. Without an offset to the repressive side effects of deficit reduction and tax reform (both desirable goals in themselves), the 1987 economic outlook becomes a choice between stagnation and borderline recession. This gives the Federal Reserve at least two good reasons for monetary accommodation: to support the domestic economic by leaning against the shift to restrictive fiscal policy, and to influence the dollar's exchange rate in international transactions.

For the short run–1987–it is assumed that mortgage rates will not stray far from their recent 9 3/4 to 10 percent range, giving continued support to the credit-sensitive single family building market. Over a longer period–perhaps the rest of the decade –the forces that are bringing stability to interest rates are reshaping the entire construction market. Call it monetary/fiscal role reversal. For much of the early half of the 1980's government economic policy could be described as "loose fiscal/



tight monetary." Highly stimulative fiscal policy (the Kemp-Roth tax cut, ERTA's supplyside investment incentives, wide-open deficit spending) was accompanied by severe monetary restraint and sky-high interest rates. To the construction sector, this meant a three-year crunch for housing and a simultaneous boom for commercial building.

'For several years ahead, Gramm-Rudman deficit targets and tax reform constitute a commitment to fiscal restraint. With inflation under control, monetary policy–through a series of cuts in the discount rate–has brought interest rates to their lowest since the 1980's began. For as long as it lasts–and that means as long as the deficit issue has a high priority–this radical turnabout of national economic policy reverses the basic thrust of the construction sector. It will be a handicap to high-rise commercial building as well as to public works construction. It will liberate the most credit sensitive parts of the market: housing and its derivatives–stores, other light commercial building, and many kinds of institutional construction.

1987 Housing Outlook Evaluation of the key factors affecting housing demand in 1987 leads to a forecast of 5 percent fewer housing starts next year.

Tax reform will make the biggest difference, and the inevitable decline of multifamily building is already under way. Stability of mortgage rates will be generally supportive of single family building through 1987, although regional dynamics indicate that next year's overall gain of up to 5 percent will be confined to the Northeast and North Central regions–the latecomers to the mid-1980's housing recovery.

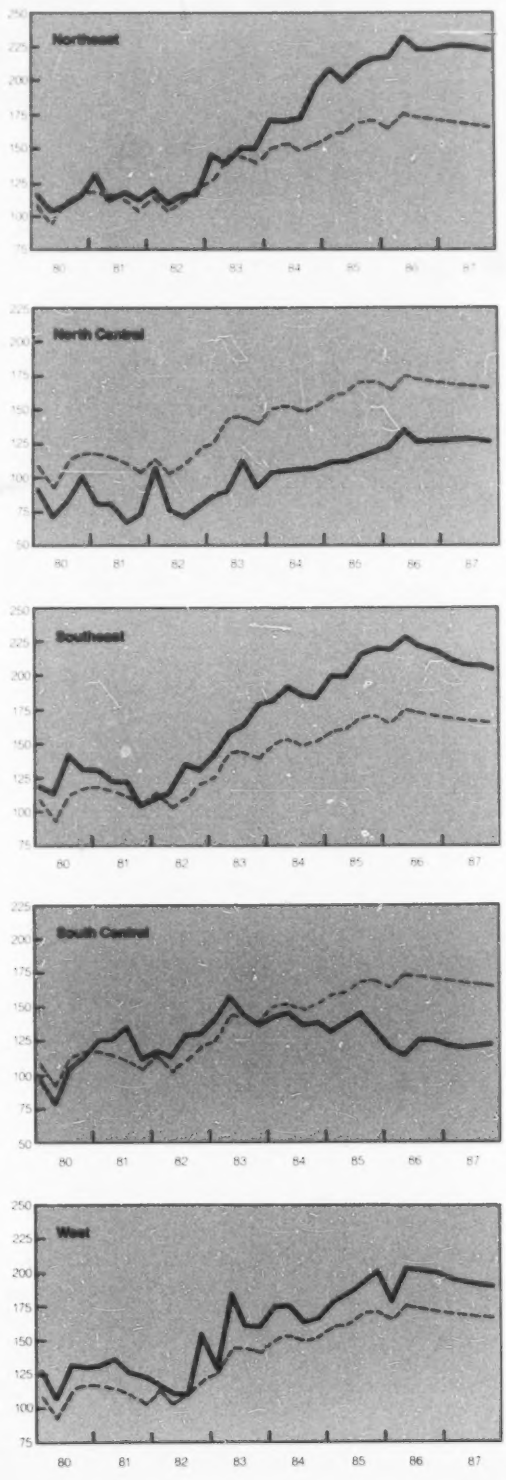
The prospect for slightly more single family houses and significantly fewer apartments adds up to a 5 percent decline of total *dwelling units* started in 1987 (1,750,000 vs. this year's 1,850,000). Owing to a different mix of housing, the decline of total *square footage*, which is a better gauge of building products demand, will be only about 3 percent.

The aggregate *value* of next year's residential building, assuming 3.5 to 4.0 percent inflation, will remain even with the 1986 total of $120 billion.

The Inner Game

Regional Indexes of Total Construction Contract Value

1977 = 100 Broken Line = U.S. Index



What Kind Of Decline Is This?

Will 1987 bring a crash or a soft landing? In the absence of a credit crunch, the cyclical decline of the construction sector will be long and gradual rather than quick and severe. The initial step down in 1987 is likely to be a small one.

The arguments for an extended decline of construction activity that will cover most of the remainder of the decade are persuasive.

- Some construction markets face several years of limited demand. The commitment to deficit reduction implies a long stretch of budgetary restraint and a continuing scarcity of funds for *public works construction*. The troublesome trade gap, which is the most immediate impediment to GNP growth, will not be closed quickly. Substandard economic growth means excess manufacturing capacity, weak business capital spending, and little improvement in *industrial construction* in the foreseeable future. For these categories, conditions in the second half of the 1980's indicate stagnation rather than decline.
- Some construction markets will be making an overdue adjustment to excess supply. By revoking ERTA's accelerated depreciation provision, the 1986 tax reform act has greatly changed the mathematics of real estate development. An extended period of sharply curtailed building is inevitable as the glut of "tax shelter" *offices, hotels, and apartments* is absorbed. These building markets are where the deep declines will be concentrated during the next several years.
- Some building markets will provide a base of continuing support not usually available during cyclical declines. The prospect of relatively stable interest rates at close to current levels means that construction of *owner-occupied housing* (single family and condos) will achieve a high percentage of their demographic potential during the second half of the decade. In addition, the prospect of a shallow housing cycle implies sustained secondary support from *retail building* as well as some types of *institutional construction*. These building markets will help to limit the depth of the decline of total construction while the vulnerable markets adapt to change.

For some categories of construction, and for some regional markets, the reversal of the construction cycle has already begun and it will broaden and deepen over the next few years. In 1987, the trade-offs between strengths and weaknesses will not work as well as they have in 1986, when total construction contract value is rounding the peak.

A group of building types making up roughly half the total—commercial and industrial buildings, multifamily housing, and public works construction—will decline an estimated 8 percent next year paced by a drop of nearly 20 percent for offices. The other half, consisting of single family housing and institutional buildings, has a potential for a collective gain of as much as 6 percent, leaving 1987's total construction contract value at $235 billion, a setback of only 2 percent. Allowance for inflation indicates a 5 percent decline in the constant dollar value of newly started construction next year.

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